

Bloomberg Barclays MSCI ESG & Green Bond Indices

Proposed Article 8 / 9 Framework based on
Joint Bloomberg and MSCI SFDR Client
Engagement

July 2021

Introduction

- As part of the EU Financing Sustainable Growth Action Plan, the EU Sustainable Finance Disclosure Regulation (SFDR) was established to lay down harmonized rules for financial market participants and financial advisers on transparency with regard to the integration of sustainability risks and the consideration of adverse sustainability impacts in their processes and the provision of sustainability-related information with respect to financial products.
- Apart from the disclosure requirements, funds promoted as ESG are required to classify as being Article 8 or 9 products, depending on whether they meet the requirements for either classification, with Article 9 taking on more restrictive disclosure requirements. Classification of Article 8 or 9 commenced in March 2021.
- Between May and June 2021, Bloomberg Index Services Limited, the administrator of the indices, and MSCI, which co-owns and provides relevant ESG data to the indices, engaged with clients to gather feedback on clients' thinking around Article 8 and 9 classification, which formed the basis of this proposed framework.
- The objective of this framework is to help clients make sense of the ESG data inputs used in the joint Bloomberg Barclays MSCI ESG and Green Bond indices, as they work towards classifying their funds. Clients are reminded that any such determination are their own obligations and this framework is intended merely as an aide. Please see the disclaimer in the back for further details.

What are Article 8 and Article 9 products as per SFDR?

Article 8

- Promotes **environmental** or **social** characteristics, or a combination



- Must have **good governance practices** (sound management structures, employee relations, staff remuneration, tax compliance)



Article 9

- Must have a **sustainable investment objective**

- **Economic activities that contribute to an environmental objective**
 - Key resource efficiency indicators (use of energy, renewable energy, raw materials, water and land, production of waste, GHG emissions, impact on biodiversity and circular economy)
- **(or) Economic activities that contribute to a social objective**
 - Tackle inequality or foster social cohesion
 - Social integration and labor relations
 - Investment in human capital or economically or socially disadvantaged communities
- **DNSH principle** (OECD, UNGPBHR, ILO, IBHR) AND **principal adverse impact indicators (14+)** to be taken into account
- **Follow good governance practices**, in particular with respect to sound management structures, employee relations, staff remuneration, tax compliance

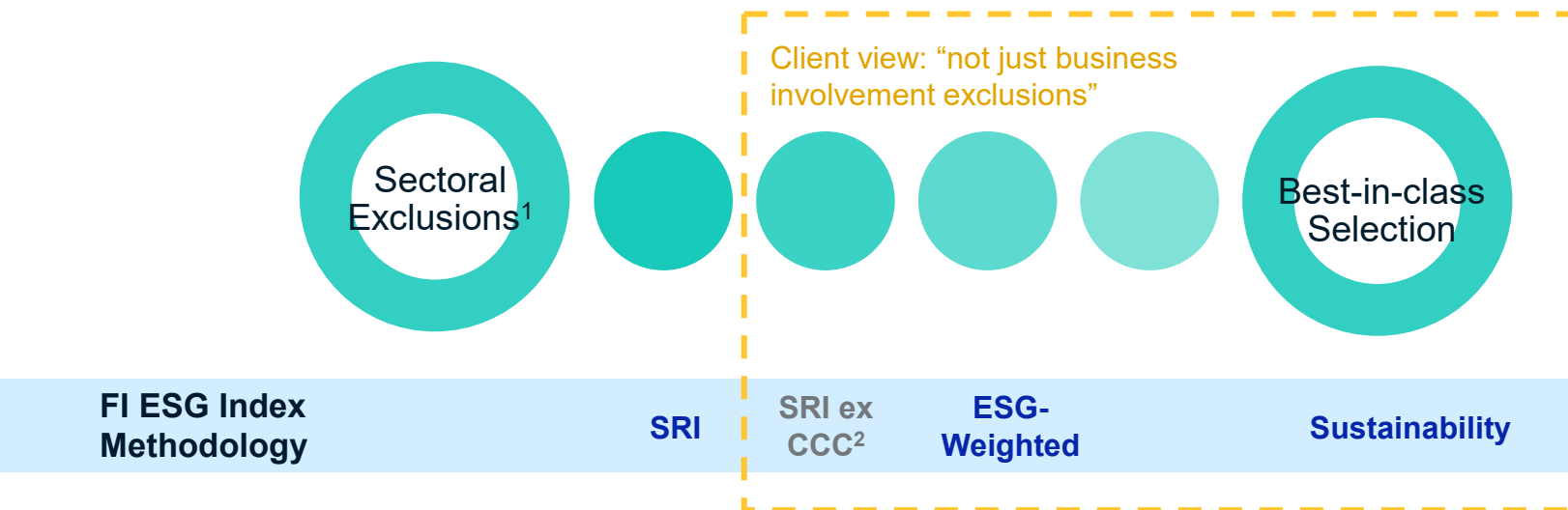
Proposed Article 8 / 9 Framework

POST-ENGAGEMENT INTERPRETATION OF KEY CONCEPTS.

Article 8: Promote Environmental or Social Characteristics

(based on client feedback)

The ESA's Final Report on the draft RTS acknowledges that Article 8 covers “various investment approaches and strategies, from **best-in-class to specific sectoral exclusions**” (Recital 18)



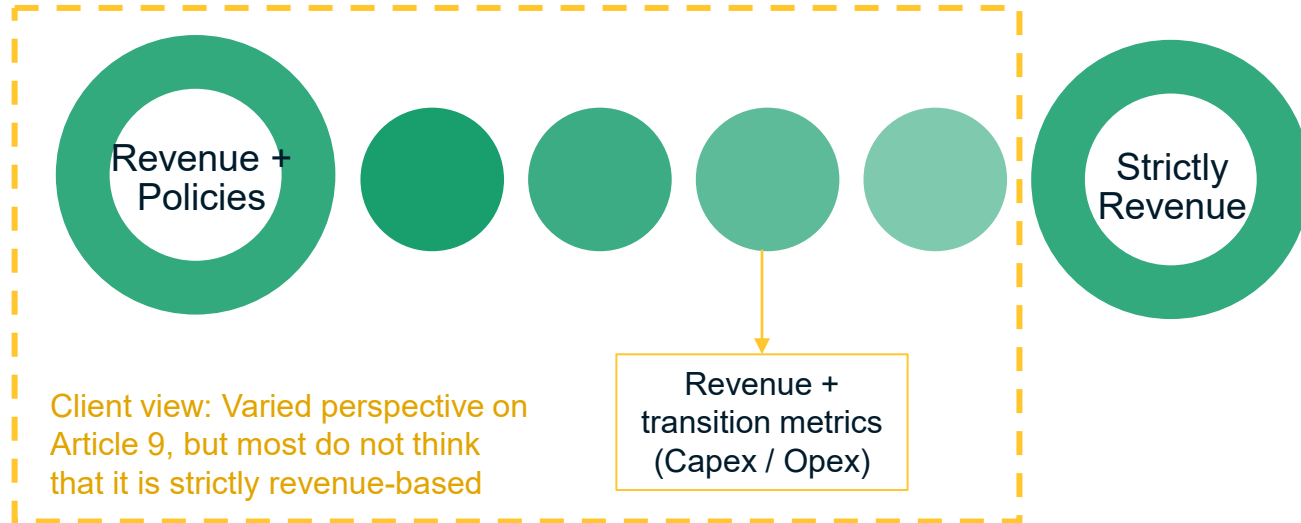
¹ Rate of material exclusion was not addressed in this slide given the lack of consensus

² A custom version of the Fixed Income SRI range of indexes referenced in the [Bloomberg Barclays MSCI ESG Fixed Income Index Family Primer](#)

Article 9: Sustainable Investment Objective

(based on client feedback)

As per Article 2(17) of the SFDR, ‘sustainable investment’ means “an investment in an **economic activity** that contributes to an environmental objective,... or an investment in an economic activity that contributes to a social objective...”



Article 9: Sustainable Investment Objective

(based on the ESA's Final Report on the draft RTS)

Article 9(3): Where a financial product has a **reduction in carbon emissions as its objective**, the information to be disclosed pursuant to Article 6(1) and (3) shall include the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement.

By way of derogation from paragraph 2 of this Article, where no EU Climate Transition Benchmark or EU Paris-aligned Benchmark in accordance with Regulation (EU) 2016/1011 of the European Parliament and of the Council (20) is available, the information referred to in Article 6 shall include a detailed explanation of how the continued effort of attaining the objective of reducing carbon emissions is ensured in view of achieving the long-term global warming objectives of the Paris Agreement.

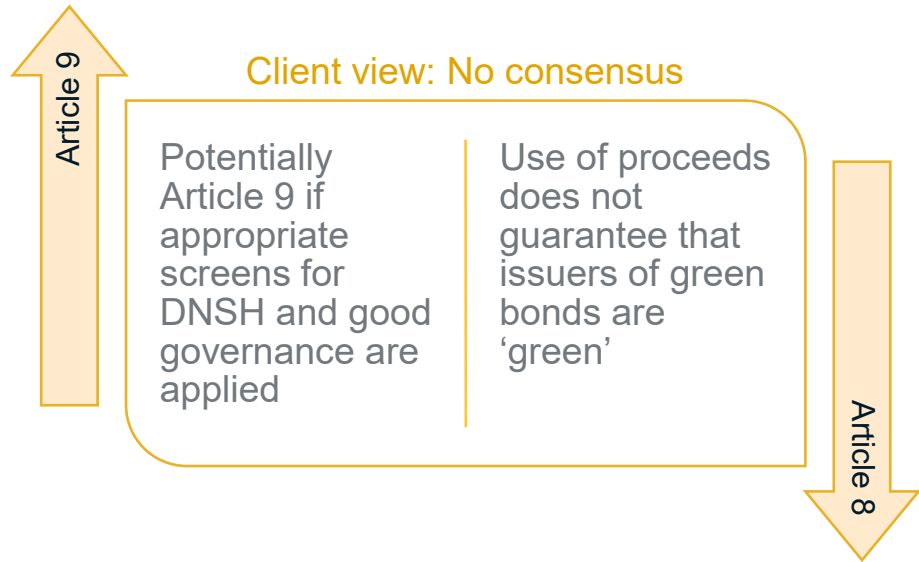
Examples:

EU Climate Transition
Benchmark

EU Paris-Aligned
Benchmark

Green Bonds in the context of Article 8 and 9

(based on client feedback)



Do clients think that the Green Bonds index methodology...

- Has environmental characteristics?

Yes, it includes bonds that are assessed as “green” as per MSCI ESG Research

- Aligns with SFDR’s Article 2(17) definition?

Depends on how “use of proceeds” are considered

- Applies SFDR’s concept of good governance?

No. Additional screens are necessary for both corporates and sovereigns

- Applies SFDR’s DNSH principle?

No. Additional screens are necessary

- Takes into account PASI?

No clear view. Some view PASI as primarily for disclosure purposes, while others view incorporating 2-3 primary PASI in the methodology

Background on MSCI Green Bonds Assessment Methodology

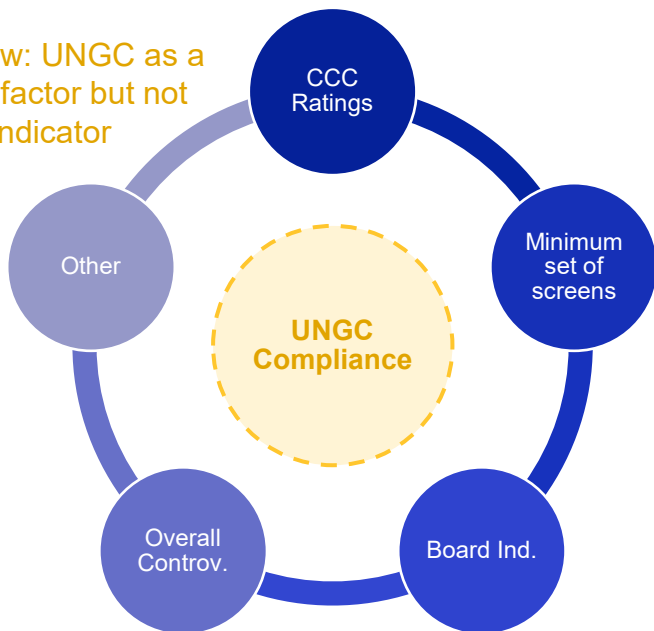
PRINCIPLE 1	USE OF PROCEEDS: Detailed taxonomy of eligible projects	MSCI ESG Research assesses the use of proceeds against seven categories categorized as “green”.	} Incorporates assessment of “harm” in a <u>limited</u> * manner
PRINCIPLE 2	PROJECT SELECTION & EVALUATION: Process for determining eligible projects	Issuers are assessed on whether they provide clear details regarding project selection.	
PRINCIPLE 3	MANAGEMENT OF PROCEEDS: Process for earmarking proceeds for eligible projects	Assessment is done to ascertain formal processes to ring-fence net proceeds to the use of proceeds.	} Incorporates assessment of some governance aspects as it relates to the use of proceeds of green bonds
PRINCIPLE 4	ONGOING REPORTING: Annual reporting of use of proceeds and impacts	Issuers are assessed on the project’s transparency or state its commitment to periodic reporting.	

Article 8 & 9: Good Governance Practices for Corporates

(based on client feedback)

The ESA's Final Report on the draft RTS determined that the definition for good governance should follow Article 2(17) of the SFDR – “in particular with respect to **sound management structures, employee relations, remuneration of staff and tax compliance.**”

Client view: UNGC as a common factor but not the sole indicator



FI ESG Index Methodology	Incorporates UNGC? ¹	Other client-noted indicators
SRI	Yes	Tobacco Military weapons Thermal Coal ²
ESG-Weighted	No	ESG Ratings
Sustainability	Yes	ESG Ratings

Article 8 & 9: Good Governance Practices for Sovereigns

(based on client feedback)

The ESA's Final Report on the draft RTS determined that the definition for good governance should follow Article 2(17) of the SFDR – “in particular with respect to **sound management structures, employee relations, remuneration of staff and tax compliance.**”

Client view: Sovereigns should comply with international standards, but there is currently a lack of consensus.

Examples:

UN Sanctions

World Bank's Worldwide Governance Indicators

Freedom House

FI ESG Index Methodology	Incorporates highlighted standards?	Other related indicators
SRI	No	
ESG-Weighted	No	ESG Ratings (Government Model)
Sustainability	No	ESG Ratings (Government Model)

Article 8 and 9: Do No Significant Harm (DNSH) Proxy*

(based on client feedback)

As per the ESA's Final Report on the draft RTS, "DNSH reporting must also show whether the investments are aligned with the **OECD Guidelines for Multinational Enterprises** and the **UN Guiding Principles on Business and Human Rights**, including the principles and rights set out in the eight fundamental conventions identified in the Declaration of the **International Labour Organisation on Fundamental Principles and Rights at Work** and the **International Bill of Human Rights**."



MSCI ESG Controversies

The current definition of SFDR's DNSH is meant to be in line with the minimum safeguards as per the EU Taxonomy Regulation – this is not the same as the Taxonomy's DNSH principle

Client view: While the idea is to align with the specified international standards for corporates, it is unclear at this stage which factors can be used for Sovereigns

Article 8 and 9: Principal Adverse Sustainability Impact (based on client feedback)

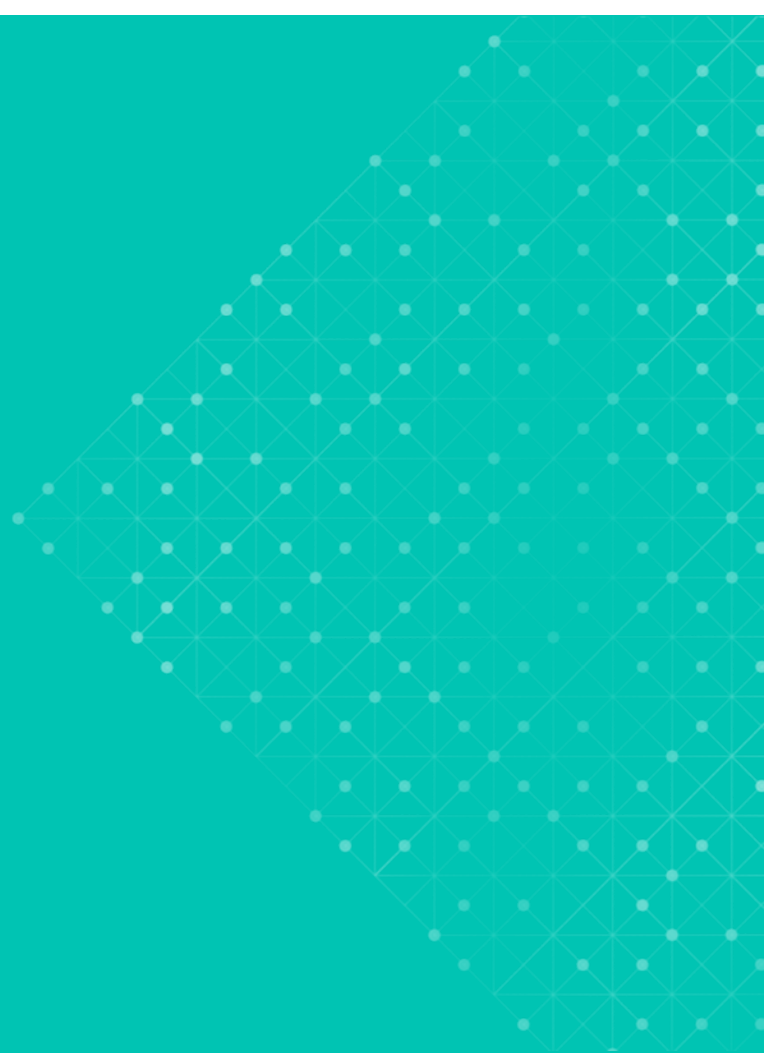
Article 16(3a) and 23(3a) of the ESA's Final Report on the draft RTS: For funds that commit to making sustainable investments or have a sustainable investment objective, the description shall include an explanation of "how the indicators for adverse impacts in Table 1 of Annex I and any relevant indicators in Tables 2 and 3 of Annex I, are taken into account..."

Client view: Seek clarity and observe for now, as they need to understand PASI before incorporating into methodologies

PASI as primarily for disclosure purposes

2-3 primary PASI indicators can be incorporated

Appendix



Results of the SFDR Engagement

OVERVIEW OF RESPONSES AS PER THE KEY ARTICLE 8 AND 9
DISTINCTIONS

Recap > Framework Questions: Article 8

1. How would you define “promoting environmental or social characteristics” in the context of fixed income ESG funds?
 - a) For exclusions-based approaches, what is your view on the below requirement?

“where there is a commitment by the financial market participant to reduce by a minimum rate the scope of investments considered prior to the application of the strategy referred to in point (a), an indication of that rate;” (Article 15(b) of the ESA’s Final Report on the draft RTS)
 - b) Do you think that the requirement implicitly requires a minimum rate or do you think that this is more a disclosure requirement to report said rate?
 - c) How are you distinguishing between “promoting environmental or social characteristics” and “environmental or social safeguards”?

2. Which ESG factors/inputs do you consider as appropriate [for corporates and/or sovereigns] to represent “good governance practices” in line with Article 2(17) definition?

“that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance” (Article 2(17) of the SFDR)

Summary of Feedback*: Article 8

Promote environmental or social characteristics

Some view pure business involvement-based exclusions as insufficient for Article 8, while others take it further and consider an element of “deliberate” selection (Top %) as a necessary element.

Other consideration: regulations and labels

A number of clients referenced other **supranational or national regulations**, as well as voluntary **national labels**.
Examples:

- * **Mifid II amendment**, which referenced an option for Article 8 based on an exclusions strategy that also either pursue sustainable investments or incorporate and mitigate principal adverse impacts.
- * **BVI’s** minimum exclusions criteria for sustainable products
- * **AMF ESG Doctrine**, which outlined the minimum standard for ensuring “significant” impact when using (and marketing based on) non-financial criteria
- * **Country labels**, such as Towards Sustainability (Febelfin), Nordic Swan, etc. that set their own standards.

Material rate of exclusion

There seems to be a **lack of consensus in terms of the “material rate” requirement**. The views can be broadly categorized into the following:

- * Purely as a disclosure requirement
- * Reduction in terms of impact (e.g., carbon footprint)
- * Reduction in stocks (market cap or number of constituents) consistent with the AMF ESG Doctrine requirement

Summary of Feedback*: Good Governance Practices

UNGC as proxy for good governance for corporates

Clients generally view **UNGC compliance as a common factor** to assess good governance for corporates, but not necessarily as the sole signal for good governance.

- * Some have noted adding other signals, such as board independence or CCC ratings
- * Some have noted that they use third-party proxy for good governance.
- * Some have emphasized that they look at a set of minimum standards to meet Article 8, for example, and not by component

Good governance for sovereigns

There was agreement that sovereigns should also comply with ideally an international standard that is comparable to UNGC for corporates. However, there is currently **no consensus on how to assess good governance for sovereigns**. Clients have pointed to a few examples:

- * UN Sanctions
- * World Bank's Worldwide Governance Indicators
- * Freedom House

Recap > Framework Questions: Article 9

1. With the exception of Article 9(3) referring to EU climate benchmarks, do you think that sustainable investment objective referring to “economic activity” is limited to impact/thematic investing using revenue as basis?

2. Which ESG factors/inputs would you consider as appropriate to represent DNSH?
 - a) Would a controversy screen suffice?
 - b) Do you think that the ESA’s requirement for DNSH refers only to corporates – and as such, means that no screen is required for sovereigns (agencies/supranationals)?

3. If funds are aiming for Article 9 product classification, how do you think should these funds take into account the principal adverse sustainability impact (PASI) indicators*? Specifically,
 - a) What are your thoughts on the minimum no. of indicators to incorporate?
 - b) What are your thoughts on the minimum rate of reduction?

Summary of Feedback*: Article 9

SFDR Article 2(17): Sustainable investment

Although Article 9 funds are required to follow the Article 2(17) definition, there remains differing views:

- * That it refers not only to revenues but considers policies
- * That it refers to revenues for simplicity but also consider R&D, Capex, Opex, etc.
- * That it refers to green bonds and EU PAB in the context of Fixed Income funds

Do No Significant Harm (DNSH)

Currently, there are two different definitions for DNSH – one for SFDR and one for the EU Taxonomy, with SFDR's DNSH equivalent to the EU Taxonomy's minimum standards. Clients see SFDR's DNSH as straightforward **alignment with the specified norms to assess DNSH for corporates** but are unclear on how to assess sovereigns.

Principal Adverse Sustainability Impact (PASI)

Clients do not have a clear view of 'taking into account' the PASI indicators and want to understand this first before integrating them. A couple of perspectives are taken:

- * PASI is primarily for disclosure purposes and not as a methodology input
- * Incorporation of all mandatory PASI indicators is ideal but is not an absolute requirement. Some clients are looking to incorporate 2-3 primary or most material indicators.

Recap > Framework Questions: Green Bonds

1. Do you think that funds focused on green bonds would classify as light green (Article 8) or dark green (Article 9)?

2. Do you think that the current green bonds methodology sufficiently covers the key elements required for either or both product classifications? Specifically,

a) Do you think that the scope of green projects* as outlined in the MSCI Green Bond Assessment Methodology would meet the sustainable investment objective definition (of environmental objectives) described in Article 2(17)?

“an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy” (Article 2(17) of the SFDR)

b) Do you think that the current green bond assessment criteria* adequately addresses green bond-specific good governance practices?

c) How would you define ‘do no significant harm’ (DNSH) in the context of green bonds?

Summary of Feedback*: Green Bonds

Green Bond funds – Article 8 vs. Article 9

There is no consensus on the SFDR classification of green bond funds.

- * Some view green bond funds as potentially Article 9 but that they need to be assessed based on DNSH and good governance (using exclusions)
- * Some view green bond funds as Article 8 as the use of proceeds does not guarantee that issuers are 'green'

MSCI Green Bonds Assessment Criteria

Some clients view the MSCI Green Bonds Assessment Methodology as **already incorporating some elements of DNSH and/or Good Governance**, although a few clients have highlighted the need to assess at issuer-level to ensure that companies that issue green bonds but also issue bonds that have negative environmental impact are not eligible.

Key concepts based on ESA's Final Report on the draft RTS

- **Environmental or social safeguards:** “As regards investments that do not qualify as sustainable or as contributing to the environmental or social characteristics promoted by the financial product, financial market participants may decide to apply some baseline environmental or social safeguards such as those referred to in Regulation (EU) 2020/852.” (Final Report on the draft RTS, page 16)
- **Environmental or social characteristics** (applies to Article 8 / “light green” products): “Financial products that promote, among other characteristics, environmental or social characteristics, or a combination of those characteristics (environmental or social characteristics) cover various investment approaches and strategies, from best-in-class to specific sectoral exclusions.” (Final Report on the draft RTS, page 15)
- **Sustainable investment objective** (applies to Article 9 / “dark green” products): Financial products that follow Article 2(17) definition of sustainable investment of the EU SFDR
- **Good governance practices:** As per the Final Report on the draft RTS, the definition for good governance should follow Article 2(17) of the EU SFDR – “in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance”
- **DNSH:** “DNSH reporting must also show whether the investments are aligned with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, including the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights.” (Final Report on the draft RTS, page 9)

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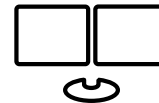
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